THE NATIONAL CITY BANK OF NEW YORK

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Economic Conditions
Government Finance

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General Business Conditions

THE uprush of the staple commodity markets has been checked and reversed in some areas during the second half of September, and for the first time since the outbreak of the Korean war a month has passed without any net rise in the indexes of sensitive commodity prices. Unfortunately the same cannot be said of wage rates, which in recent weeks have become the most important contributors to the inflation spiral, or of costs and prices of manufactured goods. Both have continued to advance. Nevertheless the check to the upsurge in staple commodities is heartening. It encourages hope that speculative buying and stocking hereafter will look a little less attractive, and that the inflationary pressures will not be augmented by excessive commitments and inventories. Every sign that an anchor is holding is welcome.

The turn in the war news since the landing near Seoul has been sensational, and victory has come in sight earlier than expected. In many quarters a tendency to review the outlook and to move a little more cautiously is seen. Few can believe, however, that the Korean news will bring any considerable modification of armament demands. The greater reason why the scramble for commodities has eased is the simple one that urgent demands in many cases, especially in lines which will be little affected by armament needs, are becoming satisfied. The rush to buy during the summer was as intense as any this country has ever known. Suddenly fearful of shortages and expecting that prices would rise, people bought new homes and automobiles in unprecedented numbers, replaced and added to their household equipment, and stored away goods in their pantries and closets. Distributors rushed orders not only to meet the demand, but to cover ahead and build up stocks. Manufacturers increased and lengthened their commitments for materials and supplies and stepped up their orders for industrial equipment, giving the machinery industries well-filled order books and contributing importantly to the general upsurge.

All such buying movements lose momentum after a time. The new purchases run ahead of final consumption, stocks and commitments are built up, business recognizes that part of the increased sales may be at the expense of future demand, and some of the pressure subsides. Probably the commodity price reaction also signifies that buyers have decided that some of the shortages were exaggerated or could be relieved. In any event the price rises produced buyer resistance. This has appeared in many raw commodities, metals being the chief exception, and also in cotton and rayon goods and other items of general merchandise.

Prices of domestic food in primary markets also have eased. Of course supplies of foodstuffs generally are ample. In most cases the demand which has run up prices includes restocking as well as consumption; and mere shifting of supplies from the producer to the distributor, or from the market into consumers' pantries, leaves them still to be consumed.

CONTENTS

An Interlude in Inflation?

Because the buying has been so largely anticipatory, and armament orders will not reach large volume for several months, the possibility of at least an interlude in the march of inflation seems to many business men worthy of consideration. Another side of the situation is that production also has risen sharply, and to record heights. The Federal Reserve Board's statisticians estimate that the Board's index of industrial production for September will approximate 212 (1935-39 = 100), compared with 207 in August, 193 in May, the month before the Korean outbreak, and 195 the high point of the 1948 boom. Of this enormous output only a small part represents arms and munitions. Never has there been such an outpouring of goods for civilian use. The sight of this flood in itself should do much to keep buyers from overloading.

At the same time the effects of the restrictions on consumer credit, put into effect during the month, and of the tightening of housing credit, are coming into view. A softening of used automobile prices is a case in point, and the decline in residential building contracts in September, accompanied by a sharp drop in applications for F.H.A. mortgage insurance, is another. In part both declines are seasonal, but seasonal influences do not provide a full explanation. Housing credit is to be tightened further, and home builders express alarm lest the industry be over-deflated, creating pools of unemployment among construction workers and materials producers. Whatever the outcome, it seems clear that demand is easing.

The problem of reducing overall demands on the country's productive facilities is simplified by the fact that so much buying, both before and since the Korean war started, has been centered on consumers' durable goods and housing. For much of this buying has been on credit. It can be readily curtailed by tightening the terms of the loans and reducing government home loan guarantees to a more sensible basis. Such restrictions, therefore, can be directly and quickly effective in choking off private demands and releasing plants and labor for armament use. By the same token it is of course possible to overdo the restrictions, and render idle productive facilities and workers in excess of what armament work can reabsorb. The responsibility of the credit authorities is to proceed by steps, testing the effect of each before proceeding to those which might prove needlessly drastic.

It is in order to add that if the restrictions are carried out in this way, as the authorities undoubtedly intend, they will command the full support of lenders, and of the country generally. Even the enormous resources of the United States cannot supply all the productive facilities needed for armament and at the same time continue housing and consumers' durable goods production at recent inflated levels. The benefits of reducing the demand by simple loan restrictions are easily seen when it is considered that the alternative would be rationing, or the issue of permits by a government body. By contrast, the loan limitations leave anyone free to buy who is able and willing to save before making the purchase, instead of afterward.

Wage Pressures

If the month's developments as above described are measured against the country's present needs it will be seen that they include a good deal that is favorable. Increased production and curtailment of demand are both wanted, to balance supplies and requirements and ease the upward pressures on prices. To the extent that these have appeared the situation is improved. On the other hand, the inflationary pressures have been augmented by a flood of wage increases, which has already engulfed much of the country's industry and plainly will engulf more. The effect is to raise costs and force up prices of manufactured goods, by which, it may be noted in passing, the cost of armament, and hence the burden on the taxpayer, is also raised. Even if prices are not lifted to cover the wage increases fully, the consequences may be inflationary because the usual result of diversion of funds from profits to wages is more spending and less saving.

A visitor from another planet might well be puzzled to discover upon what grounds these wage increases are being made. From the employers' viewpoint they are essentially the consequence of a tight labor market, present or impending; one employer – especially if fortunate enough to be making good earnings – raises wages to satisfy and hold his workers, and others are constrained to follow suit. The labor unions, however, in the interest of their public relations do not crudely demand what the market will bear but seek to convince the country that there are other economic or ethical justifications. They proffer claims that wages must be adjusted to compensate for higher living costs, that they must be adjusted to a "pre-invasion parity" with prices before controls are established, and so on.

The contentions of the unions relating to living costs disregard simple facts. By the latest figures, as of mid-August, the cost of living was still somewhat under the 1948 peak. The average

hourly earning in manufacturing, however, was \$1.463, or approximately 7 per cent above the level when the cost of living was at its highest. (This comparison ignores all the pension and other indirect wage increases received since 1948.) Another fact, which answers another of the union claims, is that the rise in the cost of living from February of this year, the postwar low, to August was less than 4 per cent, whereas the bulk of the wage demands run from 10 per cent increase upward.

The statement of President Green of the American Federation of Labor that "wages must be permitted to establish a proper basis of parity before wage controls are considered" may be judged in light of the above comparisons. The figures show that the increases now being sought and granted exceed any "basis of parity" with living costs that has existed in the past. Where the unions obtain wage gains in excess of the rise in living costs (and in excess of increases in productivity) they are not only causing inflation but casting its burden on other population groups, while escaping themselves. For it is a truism that the diversion of production to armament, and the corresponding decline in the output of civilian goods, must in some degree reduce living standards below what they might otherwise be. In short, other things being equal, the real wages of the country as a whole must fall. If the unions not only insulate themselves from this decline, but actually obtain increases, they will be doing so at the expense of other people who do not obtain equivalent pay increases but must pay the higher prices. On the other hand, if all persons received the same pay increases, thus preserving equality of sacrifice, the inflation would be general.

The A.B.A. Resolution

Government and people both bear great responsibilities in the struggle against inflation — in the effort to avert the dilution of the money supply, the depreciation of the dollar, the destruction of capital and all of the hardships, inequities and economic and social evils which go with it, and of which the country has learned much since 1939. The American Bankers Association addressed itself to this topic in its annual convention in New York during the past month. The resolution adopted by the Association September 27 read in part as follows:

> We believe that inflation at this time is unnecessary. With common-sense action by the Government and by the people, this country has the resources to meet this emergency without either inflation or detailed regimentation of the economy.
>
> Some desirable steps have been taken to resist inflation and preserve the integrity of the dollar. One such step was the prompt passage by the Congress of an act for increased taxes. The second step is restraints on consumer credit and housing credit, and these will have the full support of members of this Association.
>
> Only a beginning has been made in resisting inflation, and further action is necessary on the part of national, state and local governments, and on the part of the people themselves.
>
> The national Government should set an example by cutting back non-defense expenditures at least to the levels of 1948, which would mean a saving of about \$6 billion a year. To avoid inflationary borrowing by the Government from the banks, the Treasury should seek to distribute the national debt more widely among the people. The bankers of the Nation again pledge their aid in the campaign for the sale of savings bonds. The Government can sell savings bonds to the people more readily and with better conscience when Government itself has taken more adequate measures to insure against the decline in the buying power of the dollar.
>
> In the area of monetary policy the principle should be clearly recognized that flexibility of interest rates is effective in influencing the volume of credit and the amount of savings.
>
> Courageous fiscal and monetary policies of these sorts would reduce the need for direct controls and the need for such excessive taxation as would impair the long-range power of the country to produce.
>
> In this anti-inflationary program, the people themselves have a duty both to encourage sound government policies and to manage their own affairs so that they will produce more, spend less, and save more.

In adopting this statement the bankers expressed their faith and belief that the people of this country, working together and with their government, have the resources, physical and moral, to meet this new emergency and demonstrate once more to the world that "our way of life, with economic, political and spiritual freedom" shall weaken "the power of communism to disturb the peace and freedom of the world." If this high goal is to be reached the first requirement is understanding of the common need, and the second is unselfish cooperation in the common good.

The September-October Refunding

October 2 marks the terminus to one of the most remarkable episodes in American financial history — the effort of the Federal Reserve authorities to keep a control on their total government security holdings while offering to buy, from private holders, up to \$11 billion in four maturing issues. The Federal Reserve Banks actually acquired in five weeks \$8 billion. These, together with \$2½ billion they previously held, gave them nearly 80 per cent of the \$13½ billion overall total of the maturing issues. Even more remarkable, they sold from their \$18 billion port-

folio almost the same amount in other securities as they bought in maturing issues.

These purchases and sales, beyond any precedent for scale, had their origin in the conflicting policy announcements, by the Treasury and the Federal Reserve, on August 18. The Treasury, faced with maturities of $7,322 million in certificates and bonds on September 15, and $6,248 million more certificates on October 1, and without cash to pay them off, invited holders to take in exchange 1¼ per cent thirteen months notes maturing October 15 and November 1, 1951. These terms were the same as those offered on exchanges June 1 and July 1. They allowed no leeway for Federal Reserve open market operations to tighten up on credit.

Nevertheless, the Federal Reserve authorities determined to act, and the same afternoon announced an increase in the rediscount rate of the Federal Reserve Bank of New York from 1½ to 1¾ per cent. The particular maturity section chosen for the new issues – the second half of 1951 – was already loaded with $15.7 billion of 1¼ per cent note maturities. With credit in eager demand for financing expansion in production and inventories, and instalment purchases of homes and cars, the 1¼ per cent rate offered by the Treasury was competitively unattractive, especially to holders of maturities bearing coupons of 2 per cent and 2½ per cent. The success of the Treasury offering therefore depended on what the Reserve System was able to do.

Federal Reserve's Statement

In connection with the increase in discount rate the Federal Reserve authorities expressed a determination to "use all the means at their command to restrain further expansion of bank credit." The full text of their statement issued August 18 was as follows:

> The Board of Governors of the Federal Reserve System today approved an increase in the discount rate of the Federal Reserve Bank of New York from 1½ per cent to 1¾ per cent, effective at the opening of business Monday, August 21.
>
> Within the past six weeks loans and holdings of corporate and municipal securities have expanded by $1¾ billion at banks in leading cities alone. Such an expansion under present conditions is clearly excessive. In view of this development and to support the Government's decision to rely in major degree for the immediate future upon fiscal and credit measures to curb inflation, the Board of Governors of the Federal Reserve System and the Federal Open Market Committee are prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market.
>
> The Board is also prepared to request the Congress for additional authority should that prove necessary.
>
> Effective restraint of inflation must depend ultimately on the willingness of the American people to tax themselves adequately to meet the Government's needs on a pay-as-you-go basis. Taxation alone, however, will not do the job. Parallel and prompt restraint in the area of monetary and credit policy is essential.

It was not clear from this statement what immediate action was contemplated beyond the announced increase in discount rate. But doubts on this score vanished when trading opened on Monday, August 21. The Federal Reserve, besides putting bids in the market for the four maturing issues, began to sell large blocks of other securities from their holdings and to offer price concessions to make them move. They also allowed Treasury bills to mature from their holdings without replacement, so that the bulk of the new weekly bill issues were left for banks and other investors to absorb.

The price concessions offered by the Federal Reserve gave the holder of maturing obligations an improvement in return of a sixteenth of one per cent if, for example, he sold out and bought one-year paper supplied by them. This was an essential element in the achievement of a near-balance in Federal Reserve purchases and sales. Left for the Treasury was the task of paying off holders who preferred cash to any of the various classes of government securities available on the market.

Exchange Results

The actual exchange results, as reported by the Treasury, are summarized in the following table:

Results of September-October Exchange Operation
(In Millions of Dollars)

	2% and 2½% bonds called for 9/15/50	1⅛% certificates due 9/15/50	1⅛% certificates due 10/1/50	Total
Total outstanding	$6,125	$1,197	$6,248	$13,570
Exchanges:				
For 1¼% notes due Oct. 15, 1951	4,900	1,040	—	5,940
For 1¼% notes due Nov. 1, 1951	—	—	5,254	5,254
Unexchanged	1,225	157	994	2,376
Per cent unexchanged	20%	13%	16%	17%

The proportion unexchanged and requiring cash redemption – 17 per cent overall – was considerably above the normal range of 5 to 10 per cent. On note offerings in June and July, when the Federal Reserve paid premiums to get the maturing issues for exchange, the unexchanged proportion was a shade less than 5 per cent. The Treasury, which enjoyed an unexpected surplus in the first quarter of the new fiscal year, fortunately had more than enough money on hand to make the necessary cash redemptions, and could draw on accumulated balances with commercial

bank depositaries for the purpose. Treasury balances will be replenished early this month by a special offering of Series F and G Savings bonds to institutional investors as previously scheduled.

Of the $11.2 billion exchanged, the bulk was accounted for by the Federal Reserve Banks. Some of the new notes due October 15, 1951, which they received on exchange September 15, were sold on the market, during the second half of September, at a small discount below par, to yield the purchaser 1.34 per cent. This is the first time since 1931, when Andrew Mellon was Secretary of the Treasury, that a new government security has traded below par immediately upon issuance. In 1942, under Mr. Morgenthau, an issue backfired, but the Federal Reserve in that instance came to the rescue with a par bid.

Federal Reserve Sales

The Federal Reserve's purchase total was no more remarkable than the sales figure which, up to September 20, ran to the same general proportions. As the following summary shows, the largest reductions were in holdings of Treasury bills, which were allowed to run off; in July and August, 1951 notes; and in January, 1951 certificates. Sales of two-to-five year obligations were relatively moderate. Some bonds over five years to maturity were sold between August 16 and September 6 but later, when offerings appeared from other holders, purchases were made to maintain orderly conditions.

Federal Reserve Open Market Operations
August 16 to September 20, 1950
(In Millions of Dollars)

	Holdings Aug. 16	Holdings Sept. 20	Changes Aug. 16 to Sept. 20
Treasury bills	$ 4,271	$ 1,017	$—3,254
Certificates due 1/1/51	1,091	63	—1,028
Notes due 7/1 and 8/1/51	5,537	3,714	—1,828
Notes due 10/1/51	246	0	— 246
Notes due 10/15 and 11/1/51†	2,443*	9,736	+7,293
Notes due in 1954 and 1955	555	264	— 291
Bonds due in 2-5 years	1,618	1,171	— 447
Bonds due after 5 years	2,573	2,561	— 12
Total	$18,334	$18,526	$+ 192

†Notes due 11/1/51 were not formally issued until October 2, 1950. *Holdings of bonds and certificates due September 15, and certificates due October 1, made exchangeable for these notes in accordance with a Treasury announcement on August 18.

Some apprehensions were voiced, when the Federal Reserve began this vast enterprise, that purchases might far exceed sales and necessitate an upward revision in bank reserve requirements to mop up a resultant over-accumulation of excess reserves in the banking system. The actual achievement has shown these apprehensions to be needless. There was no accumulation of excess reserves.

In the fourth week of September, as the closing of the books on the October 1 exchange brought the episode to an end, the Federal Reserve Banks were buyers of Treasury bills to ease the pressure on banks from quarterly income tax collections, and also buyers of long-term bonds to steady their markets. These are both evidences that, in the official view, the bond market had had enough of a shock, and that more than enough pressure had been brought to bear on bank reserve positions.

Money Rate Changes

The Federal Reserve, as stated earlier, concentrated its sales effort on shorter-term issues in its portfolio. Treasury certificates and notes maturing in 1951, bearing coupon rates of 1⅛ and 1¼ per cent, were offered at small discounts below par to yield the purchaser from 1¼ to 1 5/16 per cent. On Treasury bills, runoffs from the Federal Reserve portfolio pushed the yield gradually up from 1.17 per cent to 1.32 per cent. Declines in prices of long-term bonds, mostly sympathetic to the change in the short-term market, resulted in smaller increases in yields.

The advance in discount rate, the sales of government securities out of the Federal Reserve portfolio at improved yields, and the depression of government bond quotations, led to a general realignment of open market money rates and loan rates, as the following table shows:

Short-Term Money Rates

	Aug. 18, 1950	Sept. 29, 1950
91-day Treasury bills	1.17%	1.32%
13 months' Treasury notes	1.22	1.35
90-day bankers' acceptances	1⅛	1⅜
4-6 months' prime commercial paper	1¼	1⅝
Call loan rate	1½	1¾
Prime commercial loan rate	2	2¼
Discount rate, Fed. Reserve Bank of N. Y.	1½	1¾

The normal expectancy would be that these rate changes would lead borrowers as well as banks and other lenders to review their financial programs and some marginal operations may be checked. If the effects have not been violent — or even discernible yet in current statistics — it is because the official steps taken were not of such character and extent as to force radical policy readjustments.

The More Powers Question

One brief paragraph in the Federal Reserve's policy announcement of August 18 stated that the Board of Governors was prepared to request the Congress for additional powers, "should that prove necessary." Governor Szymczak, speaking at the Annual Convention of the American Bankers Association a week ago, resurrected the "supplemental reserves" proposal, urged upon Congress a number of times in recent years. The debate on the pros and cons of this device may thus be reopened in the months ahead.

Governor Szymczak was spelling out what, in his view, might prove to be "necessary" in the event of large-scale deficit financing. Certainly consideration of any such devices is premature, to say the least. For one thing, the budget is, at the moment, balanced. With good stewardship it can stay that way for the foreseeable future. More important, the Government has within its own control the most inflationary element in the whole economic picture, namely housing credit. Until the Government has tightened up its ultra-liberal policy in guaranteeing mortgages it seems undesirable to move for stringent general credit controls.

In the area of open market operations, the action taken was a limited one for a limited objective: namely, to avoid an unnecessary encouragement to inflationary forces. After the decision was made that this objective took precedence over the realization of a high exchange percentage on the September-October refundings, the Federal Reserve authorities moved with conspicuous caution. This is no more than proper, in light of the sensitivity in the market to changes of as little as an eighth or a quarter of one per cent. Simply for the Federal Open Market Committee to set its course in the direction of restraint is a powerful cautioning influence.

"No Time for Free Lending and Spending"

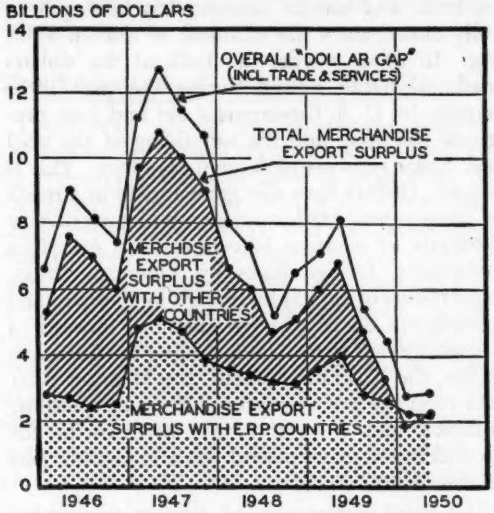
Under date of September 29, two directors of the Federal Reserve Bank of New York, John C. Traphagen and Lewis H. Brown, took the unusual step of issuing a circular letter explaining why they had voted in favor of the increase in discount rate and the "overriding and impelling economic considerations" that warranted the Federal Reserve System in "taking independent action which, while consistent with and implementing the general policy of the Government, may result in an increase in the cost of servicing the public debt." Addressed to member banks in the New York Federal Reserve District that had elected them to office, the letter, quoted in part below, gives a concise and tempered statement of the issues involved:

> The impact of general credit controls, of course, expresses itself in an increased cost of "money", in higher interest rates. These higher interest rates apply to the borrowing of individuals, of corporations, and of the Government. No way has been found to restrict the availability of credit without affecting interest rates charged all borrowers, including the Government. This has its difficult aspects, since it means that action taken by the Federal Reserve System will impinge upon the debt management prerogatives and policy of the Treasury. Ordinarily, and even extraordinarily, some composition of these overlapping authorities and responsibilities should be possible. Only overriding and impelling economic considerations, such as have recently existed, can warrant the central banking system taking independent action which, while consistent with and implementing the general policy of the Government, may result in an increase in the cost of servicing the public debt. It should be clear, of course, that the possible increase in such cost, growing out of increased short-term interest rates will be but a small fraction of the possible cost to the Treasury, and to the people of the country, of a substantial and sustained rise in prices. Increases in the cost of servicing the debt may be computed in millions; the cost of inflation in billions.
>
> We believe it should be possible to meet the requirements of a long-term rearmament program, and to prevent this program from breeding a wild inflationary splurge, even though our economy seems already to be fully engaged. We believe that direct controls of all economic processes are not the present answer; they do not prevent inflation; they merely suppress and postpone it; they attack the effects rather than the causes and bring a multitude of economic dislocations and inefficiencies. We believe that restraint in expenditure on the part of Government – Federal, State and local – and a vigorous tax policy supported by timely credit measures is the main hope of success in this effort. That is why we voted to increase the discount rate of this Bank, and that is why we are wholly in accord with the action of the Federal Open Market Committee in changing its policy so as to make reserve funds less readily available to the banks. To make this policy effective demands your cooperation and the cooperation of all the banks of the country. Your voluntary efforts in this direction will be supported and upheld by the action of the central banking system. This is no time for free lending and spending. We intend to do all in our power to preserve the integrity of the dollar, the purchasing power of wages, of profits, and of savings. We hope that you approve of what we have done and that it will have your wholehearted support.

Shifting Dollar Position

The war in Korea, and the urgent need to build defenses against aggression elsewhere, require a recasting of many plans, programs, and policies. In the area of currencies, the requirement is to combat inflation, resulting from increased armament expenditures, by appropriate fiscal and credit policies. Behind these policies lies the necessity to encourage people, in order to protect what they have, to lessen their personal demands for goods and services.

The intensified inflationary threat came at a time when our trade with Europe and the rest of the world was rapidly moving toward a reasonable balance. This is evident in the shrinkage of the "dollar gap", which plagued the Western World during the four postwar years, 1946-49, and which Marshall aid and other programs were designed to cover. Progress has been especially noteworthy since last September, when Great Britain set in motion a much-needed world-wide readjustment of exchange rates.



The "Dollar Gap" — Excess of U.S. Trade and Service Transactions with the Rest of the World — at Annual Rates by Quarters

As the chart brings out, the dollar gap – which takes into account the excess of merchandise exports together with the net income from foreign investments and net earnings from shipping, royalties, and other "services" – had narrowed in the first half of this year to an annual rate of about $2.8 billion. The greater part of this decline was accounted for by the contraction in our exports from their swollen totals of 1946-48, and a lesser part by gradual expansion in our imports.

Trade Balance By Areas

Not only has the dollar gap thus been reduced to more manageable proportions, but, except for Marshall Plan Europe and the Far East, it has virtually disappeared. All other areas, as shown in the table below, have by this time either balanced their trade with us or are actually earning more dollars than they are spending here.

One promising path for the elimination of Western Europe's dollar gap, now running at an annual rate of $2 billion as compared with almost $4 billion one year ago, lies in enlarged European trade with overseas raw material producing countries whose dollar earnings are increasing.

Meanwhile, the transactions that go to cover the dollar gap – the ERP and other grants-in-aid programs, private gifts, American direct investments overseas and a limited amount of private credits – have provided more than enough dollars to foreign countries as a whole. This development, together with the fact that most of the newly-mined gold is now being retained abroad, explains how foreign countries were able

United States Foreign Trade by Major Areas

(In Millions of Dollars)

	1st Half 1949	2nd Half 1949	1st Half 1950
	U. S. Exports, Incl. Reexports		
United Kingdom	$ 391	$ 309	$ 243
Other ERP Europe (a)	1,905	1,467	1,306
Far East (b)	597	497	382
Sub-total	2,893	2,273	1,931
Canada (c)	1,043	915	928
Latin America	1,471	1,241	1,233
Sterling Area (d)	639	458	409
All Other	571	498	390
Sub-total	3,724	3,112	2,960
Grand Total	6,617	5,385	4,891
	U. S. General Imports		
United Kingdom	112	115	126
Other ERP Europe (a)	328	288	355
Far East (b)	204	194	241
Sub-total	644	597	722
Canada (c)	761	790	881
Latin America	1,174	1,130	1,287
Sterling Area (d)	506	412	559
All Other	306	305	364
Sub-total	2,747	2,637	3,091
Grand Total	3,391	3,234	3,813
	Excess of Exports (+) or Imports (—)		
United Kingdom	+ 279	+ 194	+ 117
Other ERP Europe (a)	+1,577	+1,179	+ 951
Far East (b)	+ 393	+ 303	+ 141
Sub-total	+2,249	+1,676	+1,209
Canada (c)	+ 282	+ 125	+ 47
Latin America	+ 297	+ 111	— 54
Sterling Area (d)	+ 133	+ 46	— 150
All Other	+ 265	+ 193	+ 26
Sub-total	+ 977	+ 475	— 131
Grand Total	+3,226	+2,151	+1,078

(a) Includes Turkey, Iceland, Ireland. (b) Japan, China, Korea, Formosa, Philippines. (c) Includes Newfoundland and Labrador. (d) Excludes United Kingdom, Iceland, Ireland.

to replenish their official gold and dollar reserves by over $2 billion during the nine months period between the September 1949 devaluations and the end of June 1950.

Though the biggest gains have been reported by London, which operates the sterling area's gold and dollar pool, and by Canada and Japan, increases in gold and dollar reserves have also been reported by South Africa, the Netherlands, Sweden, Western Germany, and a number of Latin American countries. All this helps build up confidence in currencies abroad, improves the basis for private trade credits, and makes possible the easing or abandonment of restrictions on trade and on currency convertibility.

Post-Korean Trade

Expanding U. S. production and trade in the first half of 1950 led to higher prices and to increased demands for imports, while progress with industrial rehabilitation in Europe, better crops, and more competitive prices displaced American goods to some extent in foreign markets. American manufacturers in many cases tended to shift production from foreign to domestic markets, and many foreign traders switched the focus of

their attention from export to import opportunities.

The Korean war speeded these shifts. The burst of consumer buying put pressure on producers and distributors here to fill demands of the home market and, with the scheduled gearing up of production for military purposes, required larger imports of materials for which we must rely in part or wholly on foreign sources. The scheduled speeding up of the U.S. stockpiling program alone should mean an addition of some \$600 million to the imports, running prior to the Korean crisis at the rate of about \$7½ billion a year. As for the bulk commodities not stockpiled, such as coffee, cocoa, sugar, and wool, higher prices are adding several hundred million dollars to our import bill.

Though the increase in the volume and value of imports is likely to be the greatest in the case of essential raw materials and certain foodstuffs, purchases abroad may be increased also in other categories. An active demand for European steel has appeared and increased interest has been reported in overseas supplies of textiles, artificial textile fibers, plastics and specialized chemicals, tools, machinery, and automobiles.

American exports are being affected by conflicting forces. Heavy demands, both civilian and military, on domestic production presumably are cutting into export capacity in many lines. A broadening of export restrictions – now under way to insure an adequate supply of critical and strategic materials – acts directly to cut down exports. Export controls have already been extended to include cotton and steel products. Those over copper, zinc, and other strategic metals have been tightened.

On the other hand, export figures also have some strong supporting factors, chiefly higher prices, "war-scare" buying by foreigners, and easing of import restrictions abroad. The expectation that future supplies may be cut down by the defense program has spurred many foreign customers to increase orders for automobiles, tractors, machinery, tools, electrical appliances, and chemicals. Greater liberality in the granting of import permits, in the case of Latin American and the sterling area countries, may have been due partly to this consideration and partly to their heavier dollar earnings and increased currency reserves. On the whole, the export outlook for the remainder of 1950 would appear to be for well-sustained volume.

\$3 Billion Increase in Foreign Resources

While the third-quarter's statistical record is incomplete, indications are that the "dollar gap", on trade and service account, has been practically closed since the outbreak of Korean fighting. In other words, the bulk of the dollars made available abroad during the past three months by U. S. Government aid and loan programs has gone into the rebuilding of the gold and dollar reserves of foreign countries. This is not all. Dollars have also gone abroad as a result of some capital outflow, made up of such diverse elements as overseas investments by American companies, foreign loans by American banks, repatriation of capital by foreign individuals, and speculation on possible revaluations upward of certain foreign currencies including the Canadian dollar, the Australian pound, the Mexican peso, and even the pound sterling. Fears of spiralling inflation and successive tax increases in the United States have played some intangible part in the capital movement.

All these factors entered into an accelerated rise in foreign gold and dollar reserves during the third quarter. By now, twelve months after the September, 1949 currency revaluations, the building up of foreign gold and dollar reserves probably has reached \$3 billion. This means a recovery of about two-fifths of the gold and dollar assets liquidated by foreigners during the first three postwar years. Of this recovery, something over a half billion was accounted for by new gold production which has been accumulated in reserves abroad. Of the gain in holdings of dollars, \$1.1 billion was converted into gold and the rest allowed to build up in dollar deposits or short-term dollar investments.

The greater part of the conversions of dollars into gold has occurred since the outbreak of the Korean crisis. From June 30 to September 27 the U. S. gold stock declined \$757 million, a matter of 3 per cent. It is characteristic of the present international situation that very little of this gold was shipped abroad. Most of it is stored at Federal Reserve Banks, earmarked for various foreign accounts. Earmarked gold holdings here as a result have been built up to an unprecedented level above \$5 billion. Though foreign countries may prefer to keep a larger proportion of their resources in gold, they apparently still prefer to keep their gold in this country.

The preferences of foreign governments and central banks, as between gold and dollars, bear watching as disinterested evaluations by expert foreign opinion of the soundness of the American economic position. Camille Gutt gave a fair warning at the Annual Meeting of the International Monetary Fund three weeks ago when he referred to the paramount need "to stabilize and

preserve the purchasing power of all currencies, not excluding the U. S. dollar."

The Taxation of "Excess" Profits

The Korean war and the rearmament program precipitated by it have raised anew the issue of the excess profits tax. In times of great national emergency, such as war, calling for greatly enlarged government outlays, it is recognized that some part of these heavier costs can most readily be met out of business taxes. The Revenue Act of 1950, adopted by Congress last month, recognizes this principle. In addition to increasing individual income taxes by an estimated $2.7 billion a year, extending somewhat the scope of excise taxes, and closing some tax "loopholes", this measure hits corporations in two ways — (1) by increasing their income taxes by about $1.5 billion annually, and (2) by speeding up the schedule for the payment of such taxes.

And apparently this is only a beginning. In urging the new tax bill upon Congress, President Truman served notice that it was "only the first instalment" of a program of higher taxes. He indicated that it would be followed after the first of the year by a request for additional tax legislation, including among other things an excess profits tax to yield, according to Congressional tax experts, from $4 to $6 billion. While the President favored an excess profits tax, he wisely opposed including it in the interim tax bill on the ground that the introduction of so controversial a proposal would hold up action on the bill and prevent the Treasury from getting an early start in collecting more money; also he felt that Congress should have more time to study the subject so as to avoid serious inequities.

As it was, passage of the tax bill was delayed for some time by efforts of a determined group in Congress to write in an excess profits tax amendment from the floor. While these moves were defeated, the strength of excess profits tax sentiment in Congress was impressively demonstrated. Notwithstanding the fact that the Senate version of the interim bill contained a provision directing the tax-writing committees of both Chambers to include an excess profits tax, retroactive to July 1 or October 1, 1950, in the revenue bill to be introduced early next year, the House, by the overwhelming vote of 331 to 2, insisted upon a provision calling for introduction of an excess profits tax bill in the present session. The tax committees are scheduled to go to work on such a bill after the elections.

The Case For An Excess Profits Tax

The idea of an excess profits tax has a widespread appeal under present conditions.

In the first place, the very term — "excess profits" — implies something which is greater than it should be and therefore ought to be taken away, particularly in wartime. It conforms to the popular feeling that "no one should make a profit out of war".

Secondly, an excess profits tax falls, or at least should fall, heaviest on those companies whose profits are increasing and hence may be said to raise money "where it hurts the least". There is an argument for an excess profits tax as a temporary device in preference to a straight across-the-board levy which might work severe hardship on those companies whose profits are not increasing or are even decreasing.

In addition to legitimate arguments for an excess profits tax, there is of course always the pressure from demagogues and prejudiced groups who are ever ready to grasp a chance to "soak the corporations". The fact, moreover, that an excess profits tax falls upon only a relatively limited number of corporations, and thus is "hidden" from the population generally, makes it a tax that politicians easily find reasons for favoring. During the five years 1941 through 1945 when the excess profits tax was in effect, it was paid by an average of only 54,525 corporations annually, out of a total of 433,000 active corporations, or by only 1 out of 8. This meant that out of the total number of active businesses averaging 3,206,000, and including individual proprietorships and partnerships, the excess profits tax was paid by only 1 out of 60. This is just the kind of tax that politicians like.

The Case Against An Excess Profits Tax

Disregarding appeals to prejudice and political motives, what are the arguments against an excess profits tax?

The President, in his radio address of September 9, outlined three "hard, tough problems" that we must solve in order to do the defense job properly — (1) to produce the materials and equipment needed for defense, (2) to raise the money to pay the cost of the defense effort, and (3) to prevent inflation.

It is with points (2) and (3) that tax policy is primarily concerned. As regards point (2), it is clear that the excess profits tax can produce substantial amounts of revenue.

When it comes, however, to point (3) — the prevention of inflation — there is ground for dispute as to how well the excess profits tax meets

the specifications. While this tax, like any other, is anti-inflationary to the extent that it enables the Treasury to cover its expenditures without borrowing, it has shown repeatedly the serious fault of encouraging corporate waste and extravagance. Business concerns, knowing that most of what increment in profits they make will be taken from them in taxes, tend to become lax in such matters as salary and wage increases and bonuses, over-manning of shop and office forces (with consequent intensification of manpower shortages), needless advertising, costly repairs on plant and equipment, expense accounts for entertainment, etc. It is suspected that one of the reasons why labor unions are so keen for the excess profits tax lies in the belief that wage increases will come along much more easily when employers can figure that the Government is footing the bill. The incentive for economy and efficiency is greatly lessened. All of this is inflationary and tends to accentuate the very evil which the tax is intended to suppress.

What Are "Excess" Profits?

A second major weakness of the excess profits tax is the impossibility of arriving at any fair determination for each individual enterprise of what constitutes "excess" profits – either in wartime or peacetime.

Computation of a tax on "excess" profits requires, first, the determination of what are "normal" earnings, and the latter is a question on which general agreement can never be expected. In the excess profits taxes of World Wars I and II, the "base" earnings, which are wholly or partially exempt from that tax (but not from normal tax and surtax) were defined either as the average earnings of some specified prewar period, or the earnings that would represent a specified rate of return on invested capital.

While it may sound all right in theory to apply the tax to profits in excess of some prewar period, say in the present instance the average of 1946-49, actually the problem is not so simple. By no means were all companies uniformly prosperous during that period, and for those which were encountering earnings difficulties the selection of such a base period would work real hardship. Application of the tax would be particularly onerous in the case of newly-established and rapidly-growing companies, which have little or no base period of earnings but under the law must "reconstruct" such earnings – as they might have been if the companies had been in business and had experienced the same cycle that was normal for their industries.

Nor are the difficulties eliminated by allowing as a "base" for fair return some specified rate of return on invested capital, inasmuch as the latter is affected by numerous technicalities involved in the original cost of assets, accrued depreciation charges, mergers and reorganizations, property write-downs and write-ups, recapitalizations, valuation of goodwill and other intangibles, contingency and other reserves, etc. Moreover, a rate of return regarded as reasonable for an industry or an individual company having a stable record of earnings might be inadequate for others subject to greater risk. The amount of capital required varies greatly among different kinds of businesses.

While the mere determination in any one year of corporate taxable income, as defined for tax purposes by statute and by Treasury regulations built up over a period of nearly forty years, is often a costly procedure that extends for months or years, it is elementary as compared with the determination of invested capital or normal base earnings.

Impact on "Growth" Companies

In all this discussion of technicalities a basic consideration is the inability to differentiate between legitimate high earnings from valuable service rendered and actual excess profits. The maintenance of a strong America and the continued improvement in the standard of living over the long run depend upon the expansion of our industry through substantial investments in new productive capacity and in the development of new products and manufacturing processes. The "business as usual" corporation contributes nothing in this direction – it is the ambitious, growing corporation, willing to risk its capital and earnings exploiting new fields, which is primarily responsible for our progress and prosperity.

Yet it is the growing corporation which is the hardest hit by an excess profits tax. Its earnings will have been depressed during the base period by abnormally large expenditures, and trial and error operations, necessary in the development of any new product or productive capacity. As a result, its base period earnings will not be a fair measure of its earning capacity.

These considerations of the damaging effect of this tax upon initiative, efficiency, and growth are of particular importance in view of the prospect that the emergency which we face is not short-range, but may last for years. The ability of this country to defend itself and to play its part in maintaining a peaceful world will depend

upon our preserving the industrial leadership that has been our great safeguard in the past.

Relief provisions that have been written into previous excess profits tax legislation to take care of unusual hardship cases have been only partially successful, and often have merely added to the confusion. It will never be known how many man-hours of time on the part of business executives, accountants, lawyers, tax experts, and government employees have been expended in negotiations over the relief provision in the repeatedly amended Section 722 of the Revenue Act of 1940, and cases involving relief claims totalling $7 billion are still outstanding. In fact, when that Act was passed, there were cases still unsettled from the excess profits tax of World War I. Such delays are particularly hard on the small business man, who frequently cannot afford to keep up the fight and in the end has to settle for what he can get.

"War Profits Tax" or "High Profits Tax"?

These are formidable difficulties, and if they do not warrant rejection of an excess profits tax, they emphasize the need for careful study by Congress in framing its terms and conditions.

Since it is impossible to eliminate the inequities and other defects of this tax, it becomes all the more necessary to exercise restraint and moderation in its application. In particular, we need to guard against the efforts of those who would employ this tax not merely to recapture extra profits accruing to business from the war program, but also to cut down profits arbitrarily regarded as "too high". The first is a legitimate objective of wartime taxation, difficult though it may be to carry out fairly and equitably in practice. The second would introduce a new and revolutionary principle of profit limitation into the American tax system.

The distinction is between a true "war profits tax" and a "high profits tax". As was pointed out by Edward H. Collins in the September issue of Tax Review, published by The Tax Foundation, the term "excess profits tax", especially when it is employed by politicians, doesn't always mean a "war profits tax" in the true sense at all. He goes on to say:

> Frequently it is used to describe a tax levied, not on the excess of wartime profits over prewar profits, but on all profits in excess of some arbitrarily selected "normal" or "fair return on investment". Authorities distinguish sharply between these two broad classifications of excess profits taxes, which they define, respectively, as the "war profits" principle and the "high profits" principle.

The type of tax proposed by the group in Congress which sought to drive through an excess profits amendment to the Revenue Act of 1950 was not a "war profits tax" but a "high profits tax." Instead of a super-tax at very high rates applying only to earnings in excess of a pre-Korea average, it would have applied to all earnings above 75 per cent (later raised to 80) of such average. This super-tax would, of course, be additional to the taxes on all corporate income subject to normal tax and surtax, now raised to a total of 42 per cent for 1950 and 45 per cent for 1951, and to the increased personal income taxes on corporate income passed along as dividends to shareholders.

Thus, although advanced ostensibly to prevent "profiteering" out of the war program, such a super-tax would in fact reach down substantially below the level of earnings prevailing before Korea had ever burst into the news. By virtue of its low base, it would become in effect a device not only to limit war profits but to impose an arbitrarily determined ceiling upon corporation earnings generally. Senator O'Mahoney, leader of the Congressional excess profits tax advocates, expressed concern that "we are asked to delay a tax on excess profits of corporations which are reaching unheard of levels," but failed to mention the fact that wage payments and national income generally are also reaching "unheard of levels" and that the high corporation earnings which are a part of this picture are not being made on war contracts.

Adoption of the excess profits tax as a long-range proposition would be another blow weakening the enterprise system and hastening the trend towards socialism. For the enterprise system depends on incentive, and the excess profits tax singles out for its heaviest burdens those very companies which are the most efficient in holding down costs and which are pushing ahead most aggressively in developing new products and processes. All this goes back to the point mentioned earlier — that taxing to pay for a brief all-out war is an entirely different matter from taxing to pay for an expanded armament program that may continue for decades. In the kind of situation we face now, the preservation of the strength and vitality of our economic system is important not only for the future well-being of the people. It is just as important for victory as the armed program itself.

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